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AGENDA ITEM 6d

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Update on Investments in Companies Doing Business in the Sudan
- II. PROGRAM:** Global Equity
- III. RECOMMENDATION:** Information Only
- IV. ANALYSIS:**

Executive Summary

This agenda item provides an update on staff's progress to identify and engage portfolio companies doing business in Sudan. Staff remains committed to addressing the very serious and challenging situation in Sudan.

Staff continues to carry out the Investment Committee's constructive engagement plan through company and federal engagement, OFAC monitoring, and commitment to identify new and reliable sources to identify and engage companies doing business in Sudan.

Staff has received responses to the letters the Investment Committee directed staff to write. Four companies (ABB, Alcatel, Royal Dutch Shell, and Siemens) are currently doing business in Sudan. Of the three companies that CalPERS requested cease business activities in Sudan, all three stated they intend to remain in Sudan and strongly assert they are a force for good. Staff has identified "Next Steps" on Page 11 as part of CalPERS commitment to continue an aggressive and constructive engagement plan.

Background

Over the last several years, ethnic and racial tension in the Sudan has escalated to the level the U.S. Department of State characterizes as “genocide.” In recent months, it has been suggested that companies that do business in Sudan may thereby be furthering or condoning the nation’s support for terrorism or the egregious human rights violations occurring in that country. A company associated with the atrocities taking place in Sudan poses a serious risk to creating sustainable and responsible long-term value. Any such company runs myriad risks including but not limited to federal and international sanctions, substantial fines and penalties imposed by authorities, an impairment of their ability to raise capital in public markets as well as long term reputational damage.

CalPERS Constructive Engagement

Staff continues to carry out the Investment Committee direction to implement an aggressive and constructive engagement plan with companies doing business in Sudan. Investment Committee direction provided at the September and December 2005 meetings is as follows:

- Engage portfolio companies that are reported to be engaged in business activities that support genocide and human suffering in Sudan;
- Engage Federal authorities that can provide guidance in this area;
- Engage companies against which the Office of Foreign Asset Control (OFAC) has levied penalties for violating federal sanction programs specific to activities in Sudan.
- Seek new and reliable sources to identify companies engaged in non-humanitarian activities in Sudan and to support CalPERS’ constructive engagement with those companies.
- Report on a periodic basis to the Investment Committee on companies identified by staff as contributing in any way to the perpetuation of genocide and human suffering in the Sudan.

To support the Investment Committee direction, staff developed an extensive framework to support the constructive engagement plan. Over the past 18 months, staff has taken the following steps to support the aggressive engagement of companies reported as having business operations in Sudan:

- Engaged 46 external investment managers and 1,869 portfolio companies in an effort to identify companies that may be operating in Sudan.
- Built a coalition with four other public pension plans to establish an engagement process with companies doing business in Sudan.
- Identified, through the coalition with four other public pension plans, five companies to engage (ABB, Alcatel, Royal Dutch Shell, Siemens, and Total).

- Met with four of the five companies and participated in a conference call with the fifth to understand their business strategy and operations in Sudan as well as to ascertain whether the portfolio companies engaged in business activities with parties that support genocide in Sudan. Meeting summaries can be found in Attachment 1.

In addition to company engagement, Staff researched and explored several third party sources (ISS, KLD, and BGI) that could potentially identify the appropriate companies doing business in Sudan. While none of the sources proved satisfactory for a variety of reasons, staff did find the relationship with Oxford Analytica to be very constructive and detailed. Oxford Analytica's conclusion is that each foreign company doing business in Sudan needs to be considered on a case-by-case basis.

After extensive discussions with other public pension fund representatives and associations, CalPERS' staff concluded that the United States government is the only appropriate entity to identify a comprehensive list of companies that do business in Sudan. It is the one credible centralized source with the capability of understanding national security and human rights implications of company operations and directing appropriate prohibitions and sanctions against these companies. Therefore, staff took the following actions to engage the federal authorities:

- Built a second coalition of 50 pension funds to engage the U.S. Department of Commerce, U.S. Department of State, U.S. Department of the Treasury, and the U.S. Securities and Exchange Commission (Attachment 2). The U.S. Department of Commerce and U.S. Department of State provided written responses which can be found in Attachment 3.
- Staff continued with its efforts to engage the U.S. Department of the Treasury and U.S. Securities and Exchange Commission (Attachment 4) and received a response dated December 21, 2005 from the U.S. Securities and Exchange Commission (Attachment 5).

Staff continues to monitor OFAC for companies against whom OFAC has levied penalties for violating federal sanction programs specific to activities in Sudan.

Responses to CalPERS Letters

Following the Investment Committee direction received on December 12, 2005, staff wrote to the Chief Executive Officers for ABB, Alcatel, Royal Dutch Shell, Siemens, and Total (Attachment 6) communicating the Investment Committee's desires regarding the companies' activities in Sudan. Specifically, the Investment Committee directed staff to demand ABB, Alcatel, and Siemens cease their operations in Sudan, ask Royal Dutch Shell if any of the fuel sold at

its 42 service stations located in Sudan is going to the military or the government, and ask Total to update staff of any changes in its status of having no current operations in Sudan. ABB, Alcatel, Royal Dutch Shell, and Siemens have provided written responses to CalPERS' letters.

ABB Ltd

ABB responded (Attachment 7) that it has no intention of ceasing business activities in Sudan. The company firmly believes it is a force for good in Sudan. ABB also contends their decision to stay in Sudan is supported by NGOs, government officials, diplomats, and other international organizations and international companies with whom they are involved in wide-ranging stakeholder dialogue on Sudan. Further, ABB states that these organizations believe that if ABB were to cease business activities, it would undermine the positive steps that have been taken in Sudan over the past year. ABB states they have consulted Amnesty International and an international human rights expert on their position. The company also continues to be an active participant in international initiatives such as the Business Leaders Initiative on Human Rights (BLIHR) and the UN Global Compact. ABB firmly believes that constructive engagement and support is the right path to help the people of Sudan.

Siemens

In Siemens response (Attachment 8), the company expressed disappointment over the Investment Committee's demand to cease operations in Sudan and stated that, for the reasons previously communicated to staff, the company is unable to do so. Siemens believes that the company's activities in Sudan are conducted in full compliance with U.S. guidelines and various international norms. Further, the company is convinced that "part of the resolution of the situation in Sudan has to include the economic development of the country."

Siemens referenced the dilemma it would face if it withdrew from Sudan regarding its Sudanese employees and the possible legal ramification or unfavorable press if it did so because of CalPERS' demand. Siemens also referenced a provision of the German Stock Corporation Law through which other shareowners may demand the company remain in Sudan and threaten legal action should Siemens concede to CalPERS' demands. They closed the letter by stating that Siemens takes its corporate responsibility very seriously and aspires to be a good corporate citizen in all countries in which they operate.

Alcatel

Alcatel responded (Attachment 9) that ceasing operations in Sudan would not be in the best interest of the people in Sudan. Alcatel feels strongly that they are

promoting human rights through its delivery of a communications network enabling the people to be heard and communicate the tragedy in Darfur to others. The company stated that it is in no way “invested” in helping the government and that Alcatel’s engagement policy, ethics policy, statement on business practices and membership to the UN Global Compact reflect its commitment to support and respect the protection of internationally proclaimed human rights. Mr. Serge Tchuruk, CEO, reaffirmed his intent to work together with CalPERS on this issue.

Royal Dutch Shell

Royal Dutch Shell confirmed in its letter (Attachment 10) that in 2005 none of Shell Sudan’s sales volume sold through Shell operated service stations were sold to the government of Sudan. However, the company did disclose that in 2005 Shell sold a very small and immaterial amount (<4% of total volumes sold in Sudan) directly to the government of Sudan. Royal Dutch Shell also stated that it divested its Aviation business in Sudan on August 1, 2005 and has not been refueling military aircraft in Sudan for several years due to the company’s concerns that some actions of the Sudanese air force were not in line with its commitment on human rights.

New Information

Over the last two months staff has researched and engaged the Business Leaders Initiative on Human Rights (BLIHR) and the Collaborative Development Action (CDA) to learn more about their constructive role with companies doing business in Sudan. In addition, staff has begun the process of exploring both the UN Global Compact and the World Bank.

Business Leaders Initiative on Human Rights (BLIHR)

The objective of this initiative is to develop universal benchmarks that measure a company’s human rights performance. BLIHR is a three-year program and was founded in May 2003 by seven companies¹ including ABB. During 2004, an additional three companies² joined the initiative. BLIHR is supported by its honorary Chair, Mary Robinson who is the former President of Ireland and former UN High Commissioner for Human Rights. BLIHR is working on a global human rights initiative based on the United Nations Draft-Norms on Human Rights (Attachment 11). The principles guiding this initiative are based on corporate complicity. Corporate complicity can exist in direct, beneficial or silent form. The first public report describing its findings is scheduled for release in April 2006.

¹ The seven companies include ABB Ltd, Barclays plc, MTV Networks Europe, National Grid plc, Novartis Foundation for Sustainable Development, Novo Nordisk and The Body Shop International plc.

² The three companies include Hewlett-Packard Company, Statoil and Gap Inc.

Staff contacted the BLIHR regarding ABB's human rights activities in Sudan. ABB is taking steps to determine its measure of complicity in Sudan in accordance with the United Nations Draft-Norms on Human Rights. The management at ABB has committed to BLIHR to report their findings publicly as soon as possible. ABB is taking the lead in Africa to use the United Nations Draft-Norms on Human Rights as its guiding principles to evaluate the company's human rights activities on the continent, including Sudan. The company is approaching this through the evaluation of its rural electrification operations in Africa. ABB is providing a roadmap for BLIHR that could provide guidance for the establishment of human rights codes used in the selection of project contractors. ABB believes their rural electrification operations play a role in the advancement of human rights in Africa given the positive impact electrification has on improving living standards for health, education and housing.

Collaborative Development Action (CDA)

CDA was formed in 1985 and is based in Cambridge, Massachusetts. It is an independent, non-profit organization committed to improving the effectiveness of international parties that provide humanitarian assistance, engage in peace practice, and are involved in supporting sustainable development. CDA works with governments, international organizations, United Nations agencies, the World Bank, NGOs, and universities and training centers, and it is financed mostly by governments and financial institutions.

CDA focuses on the role of multinational corporations, international governments, public aid, and NGOs in countries where there are social and political tensions or conflicts. CDA initiated the Corporate Engagement Project (CEP) with the support of several governments and companies to help multinational corporations better understand their activities in conflict-torn countries. CDA has conducted field visits in Sudan and staff is exploring the viability of having CDA conduct due-diligence in Sudan on our behalf.

The United Nations Global Compact

The UN Global Compact (Attachment 12) is a voluntary, international initiative developed by Secretary-General Kofi Annan that brings companies together with UN agencies, labor and civil society to support universal environmental and social principles. Through the power of collective action, the Global Compact seeks to promote responsible corporate citizenship so that business can be part of the solution to the challenges of globalization.

The Global Compact involves all the relevant participants: governments, who defined the principles upon which the initiative is based; companies, whose actions it seeks to influence; labor, in whose hands the concrete process of

global production takes place; civil society organizations, representing the wider community of stakeholders; and the UN, the world's only truly global political forum, as an authoritative convener and facilitator.

The participants work to advance ten universal principles in the areas of human rights, labor, the environment, and anti-corruption. ABB, Alcatel, Royal Dutch Shell, Siemens, and Total have all expressed support for the Global Compact and its principles. With regard to the two human rights principles, each company has committed to support and respect the protection of internationally proclaimed human rights and to make sure that they are not complicit in human rights abuses.

Participants of the Global Compact are strongly encouraged to communicate their efforts on implementing the principles annually to stakeholders through existing communications such as annual reports or sustainability reports. The Global Compact states that the report should include the following three elements: Statement of continued support from the company's CEO, Chairman or other senior executive; Description of the actions taken to implement the ten principles during the previous fiscal year; and Measurement of outcomes or expected outcomes.

The Global Compact also publishes reports on various issues such as Conflict Prevention and Human Rights to assist all relevant participants. For example, "Enabling Economies of Peace, Public Policy for Conflict-Sensitive Business" identifies a range of concrete actions that governments and the international organizations can undertake to better assist private-sector efforts to promote effective conflict-sensitive business practices, and "Embedding Human Rights in Business Practice" explores the application of the Global Compact's human rights principles.

The World Bank

The World Bank is currently undertaking efforts to jumpstart Sudan's economic development and reconstruction in the region. The World Bank is made up of two unique development institutions owned by 184 member countries – the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). Each institution plays a different but supportive role in its mission of global poverty reduction and the improvement of living standards. The IBRD focuses on middle income and creditworthy poor countries, while IDA focuses on the poorest countries in the world. Together IBRD and IDA provide low-interest loans, interest-free credit and grants to developing countries for education, health, infrastructure, communications and many other purposes.

The World Bank recently signed an agreement with the south Sudan Government to fund development projects in that region. This is in addition to an agreement in November 2005 for purchasing medicines and school materials as well as another agreement in December to implement rehabilitation programs in Juba City that includes buildings, water, sewage system, roads and highways. The World Bank is also reported to be currently developing an economic policy for southern Sudan that is expected to help potential investors. The policy will include a framework that will address issues such as the review of the banking laws, company registration and the empowerment of southern Sudanese entrepreneurs.

Updates

Federal Engagement

Staff has continued efforts to engage federal authorities. To date, none of the federal authorities have provided guidance on Sudan. Of the four federal authorities to which staff wrote letters, only three have provided a response. As previously mentioned, the U.S. Department of Commerce and U.S. Department of State both responded in a relatively timely manner but did not offer any guidance on the matter. In addition to a written response, staff along with six other stakeholders met with senior staff at the U.S. Department of State on January 18, 2006 but were not given any guidance on the matter.

Staff recently received written correspondence from the Securities and Exchange Commission indicating that it does not have the necessary resources or authority to identify whether companies' contacts with terrorist sponsoring states are contrary to U.S. Foreign policy and humanitarian goals. No response has been received to the two letters written to the U.S. Department of the Treasury seeking input and guidance on the Sudan Initiative.

Non Government Organizations (NGOs)

Staff has made numerous attempts to contact various NGOs such as Amnesty International, CARE and Save the Children to both receive their feedback on whether they support the companies position that it is beneficial to the Sudanese people for the companies to remain in the country and to confirm where appropriate their communications with the companies. To date, staff has not received responses from the NGOs but remains diligent in their efforts to contact them.

Office of Foreign Asset Control (OFAC)

Staff continues to monitor the U.S. Department of the Treasury's OFAC for companies against whom OFAC has levied penalties for violating federal sanction programs specific to activities in Sudan. Since staff's last update to the Investment Committee in December 2005, OFAC has not levied any penalties against any of CalPERS' portfolio companies for violations of the federal sanction program for Sudan.

Staff's will submit letters of inquiry to companies against which OFAC has levied penalties for violating federal sanction programs specific to activities in Sudan. Our letter of inquiry will focus on what measures, if any, a penalized company has taken to prevent business activities from being performed in Sudan other than what is permitted under the OFAC sanctions program.

The Regents of the University of California

On January 19, 2006, The Regents of the University of California (Regents) voted unanimously to notify its external fund managers of the Regents' concern regarding assets invested in companies that are engaged in business relationships with the Sudanese government. In addition, the Regents created a taskforce, which will include UC officials and student representatives, to establish criteria for divestment and, using the criteria, identify companies for possible divestment. The taskforce is to also address the legal and financial implications of divestment on the University. It is anticipated that the Regents will vote on whether or not to divest at its meeting on March 15-16, 2006.

The California State Retirement System (CalSTRS)

At CalSTRS' Investment Committee meeting on February 2, 2006, CalSTRS staff provided its current policies to facilitate a discussion regarding how the policies relate to the issues surrounding Sudan as well as an update on their continued engagement with companies doing business in Sudan.

After a lengthy discussion, the CalSTRS Investment Committee voted against a motion to divest from PetroChina in addition to a motion having CalSTRS staff conduct further investment analysis on those companies doing business in Sudan for possible divestment. The CalSTRS Investment Committee determined that the discussion should first focus on the adequacy of existing policies. Therefore, CalSTRS staff was directed to conduct a review of their policies to determine if they adequately address social issues and if any inconsistencies exist that need to be resolved.

Meeting with California State Senator Kevin Murray

Staff met with Senator Murray on December 14, 2005 to discuss CalPERS actions regarding Sudan among other issues. Staff provided Senator Murray with an update on the agenda item presented at the December 12, 2006 Investment Committee meeting and the subsequent direction given to staff by the Investment Committee.

Council of Institutional Investors (CII)

A breakout session at the CII meeting in March has been agendized and entitled "Fiduciary Duties, Divestment, and Other Issues." CII staff expects the issues related to Sudan to be a case study for discussion.

Next Steps

Staff remains committed to the constructive engagement plan outlined by the Committee. As part of this ongoing effort, staff believes that there are still constructive paths to pursue. A number of new initiatives are listed below and involve potentially engaging both BLIHR and CDA as well as using the Corporate Governance Resource Pool to identify a third party consultant to engage the European companies. A comprehensive plan includes the following:

- Continue to actively engage portfolio companies that are reported to be engaged in business activities that support genocide and human suffering in Sudan;
 - Explore the possibility of working with BLIHR, CDA, and the World Bank.
 - Explore opportunities to use the UN Global Compact as a basis for engagement.
- Engage companies against which OFAC has levied penalties for violating federal sanction programs specific to activities in Sudan.
- Continue to seek new and reliable sources to identify and engage companies doing business in Sudan. Options currently being explored include the following:
 - Identify a third party European consultant, who has the expertise to effectively engage these European companies.
 - Explore opportunities to utilize CalPERS Corporate Governance Resource Pool to either identify global third party sources or engage companies with business operations in Sudan.
- Continue to work with the public plan coalition and to collaborate where appropriate.

Consistent with Investment Committee direction, staff will report back on a periodic basis.

V. STRATEGIC PLAN:

This item is not a product of either the 2005-2006 Strategic or Annual Plans.

VI. RESULTS/COSTS:

Over the course of last year, the primary cost to the Fund for this initiative has been significant staff time.

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